Should Personal Injury Damage Awards Be Taxed?

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Introduction

Section 104(a)(2) of the Internal Revenue Code excludes from gross income "the amount of any damages received . . . on account of personal injury or sickness." Originally enacted in 1918, the provision is almost as old as the modern federal income tax system. According to the committee report on the original legislation, the exclusion was enacted because it was "doubtful," under existing law, whether such damages were required to be included in gross income. In other words, the Committee perceived the statutory exclusion as a mere clarification of existing law.

Courts have broadened the concept of gross income significantly since 1918, but the statutory exclusion for personal injury damage awards has survived. Absent the exclusion, most damage awards would constitute gross income under the modern definition. Thus, the original exclusion was based upon what now appears to be an erroneous assumption. To the extent that the original reasoning no longer supports the exclusion, a search for alternative reasons is appropriate. One might first ask whether there is any basis in "tax theory" for excluding personal injury damage awards from gross income. If no such basis can be found, the inescapable conclusion is that the exclusion is a tax subsidy — a benefit supported, if at all, by policy considerations. To the extent Sec. 104(a)(2) represents a tax subsidy, an inquiry into the reasons for and consequences of the subsidy is appropriate.

Tax Theory

Gross income, according to Sec. 61, includes "all income from whatever source derived" unless another provision specifically excludes the item in question. Section 104(a)(2) is, of course, such a specific exclusion. While the existence of Sec. 104(a)(2) traditionally has been justified as a humanitarian gesture, more logical explanations occasionally have been offered. As illustrated below, the proffered explanations either rest on erroneous assumptions or do not justify a blanket exclusion.

Return of Capital

The most familiar justification for the exclusion from gross income of personal in-

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jury damage awards is that the recipient is merely being "made whole" by the award (see *Hawkins v. Comm'r*, 6 BTA 1023). In tax parlance, being "made whole" is viewed as a return of capital. For example, a taxpayer buys a share of stock for $100 and later sells the same share for $100, the taxpayer has no gross income because she is only recovering her original investment. Recovery of one's original investment is what is meant by "return of capital."

The return of capital analysis is appealing, especially in the case of damages awarded for loss of a limb or organ. This type of injury graphically illustrates the concept of "human capital" (see Solic. Mem. 1384, 1920-2 CB 71, for an articulation of the "human capital" concept). The problem with this analogy is that a return of capital is excluded from gross income only to the extent of the taxpayer's basis in the capital. A taxpayer's basis in property is generally the amount paid for the property (Sec. 1012). Any receipt in excess of the taxpayer's basis constitutes a taxable gain (Sec. 1001(a)). Thus, in the example above, if the taxpayer pays $100 for stock and sells it for $150, the taxpayer realizes a $50 taxable gain. However, in the personal injury context, a taxpayer's basis is zero because a taxpayer generally does not pay for his limbs or organs. The recipient of a personal injury damage award is being "made whole" in the same sense that the taxpayer selling her stock for $150 is being made whole — by receiving the full value of what is being given up. Like the taxpayer selling her stock, the personal injury plaintiff should be allowed to exclude only that portion of the award that represents recovery of an actual investment of capital. If the taxpayer's basis in the "capital" cannot be established, no part of the award can accurately be called a return of capital. Actually, it is unnecessary to speculate about whether a taxpayer has a basis in the various parts of his body. A personal injury award does not pay a taxpayer for the damage to his or her body per se; rather, the taxpayer is compensated for consequent economic loss (i.e., lost earnings) and, in some instances, pain and suffering. Such compensation clearly falls outside the scope of the return of capital concept, since no capital is being exchanged for the award.

Involuntary Transaction

Even if the plaintiff's recovery cannot accurately be characterized as a return of capital, one might be tempted to conclude that the damage award should not be taxed because of the involuntary nature of the transaction. After all, the plaintiff did not choose to be injured. The existence of other Code provisions that grant special status to "involuntary gains" might be cited in support of this conclusion. Specifically, Sec. 1033 allows a taxpayer to postpone recognition of a gain resulting from an involuntary conversion of property in certain circumstances. Normally, if the taxpayer's property is destroyed and the taxpayer is compensated for the destroyed property (by insurance or otherwise), the taxpayer will recognize a gain to the extent the compensation exceeds the basis of the property. If the taxpayer invests the compensation in replacement property, however, Sec. 1033 allows recognition of the gain to be postponed until the taxpayer disposes of the replacement property (Sec. 1033(b)).

Section 104(a)(2) might appear to be analogous to Sec. 1033, but there are two important differences. First, Sec. 1033 does not render the gain from an involuntary conversion non-taxable. Rather, it merely allows recognition of the gain to be postponed. Second, in order to qualify for deferral under Sec. 1033, the taxpayer must invest the compensation for the destroyed property in replacement property. By contrast, Sec. 104(a)(2) provides an absolute exclusion rather than a mere deferral. Moreover, the exclusion is not dependent on the taxpayer's use of the award; she may spend the money any way she likes. If would seem that the personal injury plaintiff is more like the employee who is wrongfully discharged. The employee did not ask to be fired, and his firing may have been a breach of the contract under which he was employed, but the employee is free to spend his damage recovery however he sees fit and, thus, must include it in gross income (see *Hodge v. Comm'r*, 64 TC 616, but see *Metzger v. Comm'r*, 88 TC 3000).

Imputed Income

The Internal Revenue Service and the courts have been reluctant to extend the concept of gross income to include so-called "imputed income." The generally accepted definition of imputed income is the "flow of satisfactions from durable goods owned and used by the taxpayer, or from goods and services arising out of the personal exertions of the taxpayer on his own behalf." For example, if the taxpayer, a mechanic, repairs his own car, he is enjoying the fruits of his labor. In an economic sense, the taxpayer has realized an accession to wealth. While such income arguably could be taxed, as a general rule it is not.

Damage awards sometimes represent compensation for the loss of what would have been imputed income. For example, if a husband is disabled as a result of an accident and his wife is awarded damages for the loss of the husband's household services, the damage award is a cash substitute for imputed income that would have been enjoyed tax free. Thus, it could be argued, logic requires that the damage award also be enjoyed tax free. While this is indeed the treatment under Sec. 104(a)(2), it is far from clear that logic requires such a result. It is generally agreed that imputed income escapes taxation for practical rather than logical reasons. Specifically, difficulty in defining and valuing imputed income are the main obstacles to its taxation. It appears that these obstacles are removed when imputed income is reduced to cash. Thus, while damage awards sometimes represent a substitute for non-taxable imputed income, it does not follow that such awards should be excluded from gross income on that basis.

Administrative Considerations

In addition to the theoretical justifications discussed above, certain administrative considerations are served by the exclusion of damage awards from gross income. These considerations are discussed below.

Bunching of Income.— A damage award often results in the plaintiff receiving a lump-sum income that otherwise would have been received over a number of years. This is especially true of awards compensating the plaintiff for loss of earning capacity. It might be asserted that it is unfair to subject such an award to the progressive rate structure of the federal income tax, since the bunching usually forces the recipient into a higher marginal rate bracket. This problem is avoided, of course, if the award is not taxed at all. The Tax Reform Act of 1986 lowered the maximum marginal income tax rate for individuals from 50% to 33% and reduced the number of rate brackets from 13 to three. These changes greatly reduce the perceived unfairness associated with bunching of income. To the extent that such unfairness continues to exist, some type of rate relief through averaging seems a more appropriate remedy than wholesale exclusion from gross income.

Medical Expenses.— It may be argued that, if damage awards were taxed, plaintiffs incurring large amounts of medical expenses would be saddled with tax liability in excess of their ability to pay. Assume, for example, that plaintiff is injured and incurs $20,000 in medical expenses. If plaintiff's $20,000 recovery is taxed, he or she will not have enough to pay both the tax liability and the medical bills. The deduction for medical expenses provided by Sec. 213 is of no help here, because medical expenses are not deductible if they are "compensated for by insurance or otherwise." Apparently, the tax character of the reimbursement is irrelevant (see *Litchfield v. Comm'r*, 40 TC 967, *aff'd*, 330 F.2d 509). Thus, even if the damage award were taxed, Sec. 213 would not allow a deduction for the medical expenses.

Obviously, the medical expense problem is avoided by excluding the recovery from gross income. If the recovery were taxed, however, the problem also could be avoided by amending Sec. 213 to provide that a *taxable* reimbursement of medical expenses will not preclude a deduction of those expenses.

Since the deduction for medical expenses cannot exceed adjusted gross income for the year in which the expenses are paid, a timing problem could result if the expenses were paid in a year other than the year in which the recovery is received (and, under our supposition, taxed). For example, if plaintiff recovers a lump sum in year 1 to cover future medical expenses, the medical expenses might exceed plaintiff's income for the years in which they are paid. Thus, even if the expenses are otherwise deductible (as a result of the amendment suggested above), the deduction would be of no use to plaintiff. A similar problem could arise if plaintiff pays the expenses in year 1 (presumably with borrowed money) and recovers the award in year 2. This problem does not arise, of course, if the recovery is excluded from gross income. (In some situations, taxpayers have been able to exclude the reimbursement from gross income and deduct the expenses (see *Niles v. U.S.*, 710 F.2d 1391).) If the recovery were taxed, adding a carryover-carryback feature to Sec. 213 would eliminate the potential problem.

Justification as a Tax Subsidy

The preceding discussion demonstrates why the exclusion of personal injury damage awards from gross income cannot be justified as a logical application of tax theory. To the extent that such a justification is lacking, the exclusion should be evaluated as a tax subsidy. That is, a Congressional decision to forego revenues that otherwise would be due. Although Congress apparently did not originally intend the exclusion to be a subsidy, it functions as such in the context of modern tax law.

A tax subsidy is an indirect but very real expenditure of public funds, Congress (at least in theory) having determined that such an appropriation serves the public interest. Typically, tax subsidies are provided to encourage particular activities that are deemed to be "desirable." For example, by allowing accelerated depreciation deductions, Congress has provided an incentive for manufacturers to invest in buildings and equipment, which in turn stimulates the general economy. Other tax subsidies represent government assistance through reduced tax liability to taxpayers finding themselves in unfortunate circumstances. Section 165(c)(3), for example, allows taxpayers to deduct certain casualty losses that would otherwise be nondeductible personal losses.

The exclusion provided by Sec. 104(a)(2) compensates tort victims by allowing receipts that logically should be included in gross income to escape taxation. While an expenditure of government funds for the benefit of innocent tort victims has emotional appeal, a closer inspection of the ramifications of the subsidy reveals that it is not a wise investment of public resources. As explained below, the subsidy is not fairly allocated. More importantly, government subsidization of injuries is contrary to sound tort policy.

Allocation of the Subsidy

Assuming, for the moment, that it is desirable for the government to subsidize tort feasors, tort victims, or both, it should go without saying that such a subsidy should be administered fairly and allocated consistently among those who qualify for its benefits. However, several recent developments indicate that the subsidy is not administered fairly and consistently. Rather, it is allocated in a haphazard fashion that surely would not be tolerated in the context of a direct government expenditure.

Roemer *and* Threlkeld: *Definition of Personal Injury.*— In order to be excluded under Sec. 104(a)(2), damages must be awarded on account of a "personal injury." As is often the case, it has been up to the courts to define the parameters of the term. The necessity of judicial interpretation is not unusual, nor is it an appropriate reason for criticizing a statute. However, two recent cases illustrate the possibility of inconsistent interpretations arising out of otherwise meaningless differences in state law.

In *Roemer v. Comm'r* (716 F.2d 693), the Ninth Circuit, reversing the Tax Court (79 TC 398), held that Sec. 104(a)(2) excludes from gross income damages awarded in a defamation suit, even though the award represented compensation for injury to the plaintiff's professional reputation. The taxpayer was defamed by an inaccurate credit report issued in connection with his application for an agency license from an insurance company. The Tax Court had held that the award was taxable because it represented compensation for injury to the taxpayer's professional reputation rather than his personal reputation. In reaching its decision, the appeals court set out an impressive exposition on the history of California's defamation law. On the basis of this historical background, the court concluded that defamation is a personal injury in California. Therefore, damages awarded in such an action are excluded from gross income for purposes of federal income tax.

While the result in *Roemer* may be correct, the court's reliance on state law is troubling. Unfair results are inevitable if, as the *Roemer* court held, federal tax consequences turn on state law labels. A plaintiff in state X whose case is factually identical to Mr. Roemer's and who recovers the same amount of damages might be denied the benefit of Sec. 104(a)(2) simply because state X does not label the plaintiff's injury as "personal."

The Tax Court appeared to follow *Roemer* in *James E. Threlkeld* (87 TC 1294). To its credit, the Tax Court emphasized that the label applied by state law is not determinative of whether a cause of action is based on a personal injury. Nevertheless, the court analyzed local law and in fact reached its conclusion based on its review of state law (Tennessee).

In light of *Threlkeld*, the Ninth Circuit's *Roemer* opinion cannot be dismissed as an isolated example of mistaken analysis. Whether the potential for inconsistent results inheres in the statute or results from mistaken interpretation, the problem does exist. Nor is the problem limited to the courts, as the following discussion demonstrates.

Revenue Ruling 84-108: Punitive Damages.— According to the IRS's position, the exclusion of Sec. 104(a)(2) does not extend to punitive damages (Rev. Rul. 84-108, 1984-2 CB 32). While commentators generally agree that the IRS's position is, in theory, a correct interpretation of the law, the difficulty of distinguishing punitive from compensatory damages can lead to unusual results. Revenue Rul. 84-108, the vehicle for the announcement of the IRS's position, illustrates the potential for inconsistent results arising out of state law differences. The ruling concerns payments received by the personal representatives of corporate employees who were killed in accidents involving corporate aircraft. In order to receive the payments, which were funded by an insurance company by arrangement with the employer, the personal representatives were required to release any potential wrongful death claims against the employer. The ruling addresses identical facts arising in two different states and concludes that a payment in lieu of damages recoverable under Virginia law is excludable, while a payment in lieu of damages recoverable under Alabama law is not excludable. The IRS based the distinction on the fact that damages under the Alabama wrongful death act are determined solely on the basis of the degree of fault on the part of the defendant and thus are "punitive" in nature. Virginia law, on the other hand, provides for damages to be determined according to the actual loss suffered by the decedent's survivors. Thus, damages received under Virginia law are not punitive and therefore are excluded from taxation by Sec. 104(a)(2).

While Rev. Rul. 84-108 dramatically illustrates the potential for unfair results under Sec. 104(a)(2), its analysis rests on firmer ground than that of *Roemer* and *Threlkeld*. In *Roemer* and *Threlkeld*, the courts applied state law to define "personal injury" — the words of a federal statute. In Rev. Rul. 84-108, the term "personal injury" was not in question. Starting from the admittedly supportable assumption that Sec. 104(a)(2) excludes damages intended to compensate the plaintiff but not damages intended to punish the defendant, the ruling looks to state law simply to determine the nature of the damages. The analysis is rigid, but unlike the analyses in *Roemer* and *Threlkeld*, it cannot be called incorrect. Thus, even if *Roemer* and *Threlkeld* can be dismissed as erroneous, Rev. Rul. 84-108 leads to the conclusion that a correctly interpreted Sec. 104(a)(2) sometimes yields unfair results.

Evidence and Jury Instructions.— Instructing the jury as to the tax treatment of a damage award presumably would have an effect on the amount of the award. For example, if the jury awards the plaintiff $1 million, believing that the plaintiff will have to pay tax on the award, it could be assumed that the jury would award something less than $1 million if instructed that the award is tax free (see *Domeracki v. Humble Oil & Refining Co.*, 443 F.2d 1245). If at least part of the award constitutes a replacement for lost earnings, the size of the award would also be affected if the defendant is permitted to introduce evidence of the tax the plaintiff would have paid on those earnings. In other words, the defendant would want the award to be based on the plaintiff's "take home pay," while the plaintiff would prefer an award based on his "gross pay."

In lawsuits arising under state substantive law, state law determines whether a defendant is entitled to introduce evidence on taxes and have the jury instructed that an award is non-taxable. Not surprisingly, the results are inconsistent from state to state, but courts in most states do not allow instructions to juries concerning the tax treatment of potential awards. The rationale behind the rule is that a jury instructed to find the actual amount of a plaintiff's damages would not normally be expected to go beyond the given instructions and increase its award to cover the plaintiff's perceived tax liability (*Norfolk & Western Railway Co. v. Liepelt*, 444 U.S. 490). Moreover, a jury may find that predicting future tax consequences is too complicated. The minority of state courts that have allowed evidence and instructions on taxability offer the converse rationale, for example, absent such evidence and instructions the jury might erroneously calculate the amount of the award, and, believing the award to be taxable, inflate the amount of the verdict to cover that presumed liability. It causes no harm, the courts reason, to dispel any possible misconceptions about the taxability of the award (see *Burlington Northern, Inc. v. Boxberger*, 529 F.2d 284).

In *Norfolk & Western Railway Co. v. Liepelt* (cited above), the Supreme Court held that an Illinois trial court erred in refusing to allow evidence of tax liability on lost wages and a jury instruction on the non-taxability of a potential award under the Federal Employers' Liability Act. The Court observed that absent such evidence and instructions, jurors would be likely to arrive at an erroneous damage award and further inflate the amount of the award to take into account the presumed tax liability. Two dissenting justices argued that allowing such evidence amounted to appropriation for the defendant a subsidy intended for the plaintiff, and that the jury instruction would unnecessarily confuse the jury.

Since the *Liepelt* decision involved a federal cause of action, it is not binding for lawsuits based on state law. The extent to which state courts will follow the Court's lead remains to be seen, but it is unlikely that a uniform approach will evolve. As long as different states employ different rules, the potential exists for widely varying results. In the *Liepelt* case, for example, the original award was $775,000, while the correct amount, under the Court's analysis, apparently would have been $138,000. As discussed below, the result is unsatisfactory under both *Liepelt* and the majority of state courts' approach. Even if it is assumed that one approach or the other can be deemed "correct," and that Sec. 104(a)(2) serves a worthwhile purpose, the potential for such wild variation in verdicts solely because of local rules of evidence and procedure suggests that Sec. 104(a)(2) does not serve its purpose effectively.

Niles v. U.S.: *The Double Subsidy.*— As explained above, medical expenses are deductible except to the extent the taxpayer is reimbursed for those expenses (Sec. 213(a)). If the award or settlement allocates a specific amount to past or future medical expenses, the amount allocated to past medical expenses is included in the plaintiff's gross income to the extent the plaintiff deducted the expenses when they were originally paid (Reg. Sec. 1.213-1(g)(1)). Future medical expenses will be deductible only to the extent such expenses exceed the amount allocated to them in the award (Rev. Rul. 75-232, 1975-1 CB 94).

Problems arise when the award or settlement is a lump sum with no allocation among the various components. The IRS's position is that a portion of the settlement must be allocated to medical expenses on the basis of all the facts and circumstances (Rev. Rul. 79-427, 1979-2 CB 120). Once the appropriate amount has been determined, the tax consequences are the same as outlined above. The Ninth Circuit rejected the IRS's position in *Niles v. U.S.* (710 F.2d 1391). In *Niles*, the taxpayer had recovered a $25,000 verdict against the City of San Rafael, California, as a result of an injury sustained on the school playground, and a $4,000,000 verdict against the hospital that was allegedly negligent in treating the injury. The jury did not allocate its verdict among the various components, but on appeal the taxpayer presented an itemization of the award in response to the defendants' claim that the award was excessive. That hypothetical itemization allocated $1,588,176 to future medical expenses and attendant care. In a later year, when the taxpayer claimed a deduction for those expenses, the IRS denied the deduction because the expenses had been compensated for by the award. The district court (520 F. Supp. 808) held that the medical expenses were fully deductible, and the court of appeals affirmed, stating "[m]edical expenses of a taxpayer are not 'compensated for' within the meaning of . . . [Sec.] 213(a) by any portion of a previous lump-sum personal injury award."

The *Niles* holding results in a double subsidy for the taxpayer. The award is excluded from gross income, and the expenses the award compensates for are deductible. Setting aside the question of whether a subsidy for medical expenses is appropriate, subsidizing them is a waste of public funds. Nevertheless, such a result is inevitable unless the IRS's position is followed. The problem with the IRS's position, as pointed out by the *Niles* court, is that it requires speculation as to what portion of an award represents compensation for medical expenses. The Ninth Circuit's rule, on the other hand, creates the potential for radically different results for similarly situated taxpayers solely on the basis of whether the jury itemizes its verdict. The problem could be solved by taxing the award and allowing a deduction for the medical expenses, even though "compensated for," provided the compensation is included in gross income.

Tort Policy

The primary function of the tort system is cost allocation. In appropriate circumstances, the cost of an injury is shifted from the injured party to the party causing the injury. Presumably, the party causing the injury passes the cost on to its customers, employees, and other constituents. This allocation of cost has the secondary effect of regulating conduct. In theory, if the accident costs associated with an activity exceed the benefits derived from the activity, people will find a safer way of engaging in the activity or abandon it altogether. This line of analysis is suggested by the definition of negligence in *U.S. v. Carroll Towing Co.* (159 F. 2d 169), which suggests that conduct is negligent if the cost of a potential injury, multiplied by the likelihood of that injury occuring, exceeds the burden of taking precautions adequate to prevent the injury.

Regardless of whether one subscribes to the interpretation of this standard as a law of economics, it must be conceded that the tort system discourages reckless conduct and encourages the safest manner, within reason, of carrying out worthwhile activities. The following discussion explores the impact of Sec. 104(a)(2) on the cost allocation and regulatory functions of the tort system.

As outlined above, a personal injury damage award represents an accession to wealth not inherently different from any other and therefore logically should be included in gross income. Accordingly, taxation of the award will be treated as the "correct" result and used as a basis for evaluating various alternative results that are possible under the present rule of excluding the award from gross income.

Let us assume that a plaintiff has been injured as a result of a defendant's negligent conduct. The plaintiff's lost wages, lost earning capacity, and pain and suffering have a total value of $100,000 (the plaintiff's medical expenses will be disregarded on the assumption that a deduction under Sec. 213 would offset any inclusion in gross income). If the jury awards the plaintiff $100,000, plaintiff's wealth has been increased by $100,000 and defendant has been assessed with the cost of the injury he caused. Since the plaintiff has been enriched, he should pay tax the same as if he had earned the money. For simplicity, a 28% rate will be assumed. Thus, the plaintiff will owe $28,000 in tax, leaving plaintiff with $72,000, the proper "after tax" recovery.

Situation #1 — The Typical Result under Current Law

On the facts outlined above, the result under current law is that the plaintiff gets to keep the entire $100,000 instead of paying $28,000 in tax. The cost to defendant, $100,000, is the same. Plaintiff is receiving an extra $28,000, which ultimately comes, of course, from the federal government. This is objectionable for a number of reasons. First, allowing the federal government to contribute toward the cost of injuries is contrary to the basic premise of tort law: that the party negligently causing the injury should bear its cost. If the public desires a government-funded accident insurance program, Congress should address the idea directly. A subsidy to the plaintiff also creates economic distortions. First, the plaintiff is being told that $10 of compensation for lost wages is worth $14 of income earned on the job. This is economically unsound. In addition, if an injury with a true after tax economic value of $72,000 will net an after tax return of $100,000, the $28,000 premium adds an incentive to pursue questionable claims. Finally, if an injury will yield compensation in excess of the actual loss, there is, at least in theory, an economic incentive to become an accident victim.

Situation #2 — The Jury Inflates the Award to Cover Imaginary Taxes

Let us assume the same facts outlined above except that the jury, erroneously believing that the award will be taxed, increases the award to $139,000 to allow for the taxes. Now, the plaintiff, who should end up with $72,000 after taxes, walks away with $139,000 tax free. Of the extra $67,000, the defendant pays $39,000 and the federal government pays $28,000. The message to the plaintiff is the same as in Situation #1, only louder. The plaintiff now learns that $10 of compensation for lost wages is worth $19 of wages earned on the job, or, put another way, sitting at home injured for one month pays the same as working for two months. The incentive to pursue questionable claims and the premium on becoming an accident victim are correspondingly increased.

On the other side of the equation, the defendant is now being charged $139,000 for a $100,000 injury. Although the extra $39,000 was not intended to be a punitive damage award, it functions as one. If this scenario is repeated often enough, the defendant will be driven out of business without economic justification.

Situation #3 — The Jury Reduces the Award Because It Is Tax Free

Once again, let us assume that defendant has negligently caused a $100,000 injury to plaintiff. This time, however, assume that the jury knows its award is tax free and therefore reduces the award to $72,000 on the theory that the plaintiff is receiving an indirect subsidy of $28,000 from the federal government. Under this scenario, plaintiff walks away with the correct amount — $72,000. The defendant, however, has caused a $100,000 injury and is paying only $72,000. Quite simply, the jury has taken the $28,000 government subsidy away from the plaintiff and given it to the defendant, converting the Sec. 104(a)(2) exclusion into a pure, government-funded insurance program. This conversion frustrates the regulatory function of the tort system. When the cost of an accident to the defendant is reduced through a government subsidy, the economic incentive to avoid an accident is reduced. In legal terms, the standard of care is lowered.

Situation #4 — The Award Is Taxed But the Jury Erroneously Assumes It Is Tax Free

Finally, one should consider what happens if the award is taxed, but the jury erroneously assumes that it is tax free and therefore reduces the amount of the award. As outlined above, the "correct" result is achieved if the award is taxed and the jury ignores tax considerations in arriving at the amount. Under that scenario, the defendant pays the full cost of the injury and the plaintiff gets to keep his or her "fair share." If, however, the award is taxed and the jury reduces the amount believing it is tax free, the situation is as egregious as any of the other possibilities discussed above. Using the same dollar amounts, if the jury found that the defendant caused $100,000 worth of damages, but reduced the award to $72,000 thinking it was tax free, the defendant would pay less than the "correct" amount. As stated above, reducing the cost of the accident to the defendant reduces the standard of care. At the same time, the plaintiff is not adequately compensated. Instead of the correct recovery of $72,000, the plaintiff is left with only $51,840 after tax. Besides the unfairness of undercompensation on an individual basis, repeated undercompensation of plaintiffs would reduce the incentive to sue and thus frustrate the regulatory function of the tort system.

The preceding examples illustrate that regardless of how the jury deals with the tax character of a non-taxable award, economic distortions and frustrations of tort policy are inevitable. The inescapable conclusion is that an exclusion of damage awards from the gross income is fundamentally unsound from a tort policy standpoint. (At least one commentator has suggested that repeal of Sec. 104(a)(2) would no doubt lead to larger verdicts and higher insurance premiums.)

Even if awards were taxed, distortions could still result if the jury were not properly instructed. In the case of a taxable award, the logically correct instruction would be none at all, since tax considerations should be ignored. This assumes, however, that the jury will not engage in misguided speculation as to tax consequences. The potential consequences of such speculation, as illustrated above, warrant a cautionary instruction to the jury that they should not consider the effect of income taxes in arriving at the amount of the award.

Conclusion

The exclusion of personal injury damage awards from gross income is inconsistent with established principles of taxation. Damage awards cannot accurately be characterized as a return of capital. Nor does the involuntary nature of the transaction justify the exclusion. While so-called imputed income is not taxed, the reasons supporting its non-taxability do not extend to damage awards representing a cash substitute for such income. Excluding damage awards avoids certain administrative problems that may otherwise arise, but those problems could be resolved by less drastic means.

Absent a logical explanation based on tax theory, the exclusion of damage awards must be viewed as a tax subsidy — a decision (conscious or otherwise) to forego revenue that otherwise would be due. Because of definitional, evidentiary, and choice of law problems, the subsidy afforded by Sec. 104(a)(2) is unfairly administered. More importantly, government subsidization of accident costs is inconsistent with tort policy objectives.

There appear to be few, if any, valid reasons for the existence of Sec. 104(a)(2). The reasons for its repeal appear numerous and persuasive. If damage awards were taxed, the policy goals of the tort system would be advanced rather than frustrated, since defendants would not be under-penalized and plaintiffs would not be overcompensated. In order to assure this result, however, juries should be cautioned to ignore tax consequences in determining the amount of awards.

[*Editor's Note*: In regard to an area of the tax code related to the "personal injury award exclusion," it should be noted that the Technical and Miscellaneous Revenue Act of 1988 provides that a personal injury liability assignment is treated as a qualified assignment notwithstanding the fact that the recipient is provided creditor's rights against the assignee greater than those of a general creditor. No amount is currently includable in the recipient's income solely because the recipient is provided creditor's rights greater than those of a general creditor. (See TAMRA Sec. 6079, striking Code Sec. 130(c)(2)(C) and amending Code Sec. 130(c).)]